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Accumulating growth in small doses

The Flinders Emerging Companies Fund targets small cap growth stocks with a disciplined approach to the fertile yet ambitious sector.

Wealth managers often speak of the need for investors to be diversified, questioning the pattern to follow the money to earn the return of the crowd.

It's also widely known traditional Australian equities portfolios are stacked with the country's top 20 to 100 stocks, yet there are more than 2000 other smaller companies to invest.

Flinders Investment Partners co-founder and portfolio manager Andrew Mouchacca says the outlook for earnings growth in those smaller companies – think the S&P/ASX Small Ordinaries Index – currently stands at double digits, while the ASX top 50 remains in single figures.

The case for small caps

It becomes a compelling argument to invest in the small and emerging companies sector, a specialty area for Mouchacca and his experienced co-portfolio managers. Importantly, the history of this sector has delivered solid performance.

"If we consider the Flinders Emerging Companies Fund, we've delivered more than 16% for investors since our inception and currently the fundamentals of our portfolio look extremely attractive," he says.

"We trade at a higher earnings growth than the market and we're cheaper than the market too."

While the fund can be complementary to an investor's diversification strategy, Mouchacca adds it's important to keep in mind that Flinders is not trying to be "all things to all people."

Undoubtedly the vast range of companies in the fund's investment universe makes the portfolio managers' task all the more challenging. This is where the investment team, which consists of three founding partners, draws on its experience in asset management with small companies being their "bread and butter".

"It's incumbent on us to actually identify those stocks as early as possible in their evolution to deliver maximum returns for our investors," Mouchacca says.

"There are real companies that live in this part of the market that are ambitious enough to consider themselves the next large cap stock.

"It's incumbent on us as part of our research program to identify the names with the best return characteristics but not with the commensurate risk. That allows us to construct portfolios with lower volatility and better returns."

He adds this is vital because the inherent risk in the sector is real. It comes about primarily due to a lack of efficiency in equity markets. Small companies are less efficient than larger companies and microcaps are less efficient again.

Checks and balances

Although the opportunity set in small and emerging companies is exciting, there has to be a disciplined research and investment process.

"Firstly it's about recognising what constitutes a growth or emerging company," Mouchacca says.

This includes screening out companies with high financial risk, poor liquidity or a market capitalisation that is too small. It reduces the number of stocks in the investment universe to about 300, he adds.

The asset manager then begins its proprietary research looking at a company's growth opportunities. It assesses the company's growth strategy and whether it's applicable in current market conditions – and this includes assessing the quality of management, industry dynamics, execution risks and an overall ESG assessment.

"Secondly it's about what you ought to pay," Mouchacca says.

He says this research is more about the financial analysis of the company – its earnings, cashflow and balance sheet modelling as well as its valuation. In a research paper earlier this year, Flinders provided an example of its valuation views.

"Over the last 12 to 18 months the smaller end of the Small Ords index has provided strong growth opportunities without the need to 'pay up'," the manager said in January.

It split high growth industrial stocks into two groups to illustrate the point, whereby:

- Industrial names in the top largest half of Small Ords constituents with more than 20% earnings per share (EPS) growth in FY18 had a price to earnings (PE) ratio of 34.8 times
- Industrial names in the bottom smallest half of Small Ords constituents with more than 20% EPS growth in FY18 had a PE ratio of 19.8 times

Here, the smaller stocks continued to offer a fertile hunting ground for high growth. It also believed the gap between the two was unsustainable; offering a clear alpha opportunity.

"Consequently this is the part of the market that we have been focused on, including some stocks outside of the ASX300," it said.

The quote

It's incumbent on us to identify the names with the best return characteristics but not with the commensurate risk.

Watch the video on www.fsitv.com

Mouchacca says what you won't find at Flinders is just allowing "our stocks to run and us following momentum."

"We're very rigorous in the application of valuation. We will take profits when we need to, and we'll reinvest in opportunities that look more attractive and continue to deliver returns for our clients," he says.

Rounding out Flinders' research and investment process are five key questions:

- What is the growth potential – will growth be organic, by acquisition or a cyclical event and can this growth be sustainable
- Can management deliver – management must be able to execute the growth strategy
- What's the financial strength – through Flinders' proprietary modelling, the growth company must be able to meet the asset manager's expectations
- What are the risks – are risks material and can they be managed or how will they impact future growth and valuation
- What price should we pay – financial modelling takes into account the prevailing share price as well as competitor valuations

Hot or not

In its latest quarterly update to investors, Flinders said among the stocks it added to its portfolio was insurance broker AUB Group.

"Since releasing an excellent full year profit result and growth outlook, the share price has eased with many financial services companies associated with the Hayne Royal Commission. Given the limited relevance of the commission to AUB's businesses, we have seen a valuation gap open up," the manager says.

It also re-established a position in ferry and tourism operator, Sealink Travel Group.

"The company is coming off a disappointing FY18 that was characterised by increased cost establishing new ferry routes, restructuring new businesses and higher than usual maintenance spend. With much of this behind them, we feel Sealink is in for a better 2019 and took the opportunity to buy back in."

The fund sold its position in Sino Gas & Energy during the quarter, following the takeover by Lone Star. It was the top contributor for the 12 months to September 2018.

The fund also exited Nufarm and Speedcast. At the end of the quarter the Flinders Emerging Companies Fund held 41 stocks and was holding 3.7% in cash. FS